The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 5, Number 7 February 16, 2012

Distressed Debt

A New Year in Old World Distressed Debt: Distressed Investment Opportunities for Hedge Fund Managers in the UK/Europe for 2012

By Solomon J. Noh, *Shearman & Sterling LLP*

The UK and Europe appear poised to provide unprecedented opportunities in distressed debt in 2012. A variety of factors are expected to force banks in the UK/Europe to delever their balance sheets by a colossal sum of €1.5 to €2.5 trillion over the next 18 to 24 months. Analysts anticipate, as a result, a spate of distressed bank loans coming to market.

In addition, it is widely expected that fresh inventories of underperforming loans will continue to surface in the UK/Europe due to the developing "perfect storm" of stagnating growth, dearth of high-yield financing and looming debt maturities totaling well in excess of €100 billion, all against the backdrop of the European sovereign debt crisis. Some analysts predict that high-yield default rates will more than double from 2.6% at the end of 2011 to 5.6% in 2012.

For the past few years, hedge fund managers in the US have been keenly focused on this developing opportunity. Notable distressed investment funds have devoted an increasing amount of time and resources to the UK/European strategy, such as by deepening their bench of experienced analysts and opening offices in London and/or Paris. Even managers who traditionally have focused exclusively on investments in the US have turned their attention in growing numbers to European situations.

The root cause of this phenomenon is the slowly shifting incentive structure facing banks in the UK and Europe. Due to a variety of capital and regulatory reasons, since the onset of the financial crisis in 2008, US banks have been incentivized to sell off large chunks of their loan portfolios, even at a substantial discount, rather than hold the loans with reserves or other impairments to capital. Banks in the UK and Europe, by contrast, do not appear to have faced the same types of pressures or incentives. In fact, many of those banks still tend to attribute full value to loans that by most reasonable accounts are severely distressed. Because many underperforming loans remain marked at par, and are offered for sale at par value, the market thus far has witnessed a misalignment in expectations between UK/European banks, on the one hand, and distressed investment funds, on the other. Hedge funds typically only buy assets at a steeply discounted price in order to ensure an acceptable rate of return for their investors. As a result of this mismatch, the distressed investment activity in the UK/Europe remained stagnant throughout much of 2011.

For various reasons, many expect 2012 to bring about a resurgence in distressed debt investing. Among other factors, the implementation of Basel III – a global regulatory standard on bank capital adequacy – will require banks to hold higher quality capital. The shifting regulatory environment, in turn, is likely to force banks in the UK and Europe to downsize their balance sheets significantly and in a hurry. If the banks are to respond with a slew of asset sales (as many anticipate), distressed investment funds – estimated to hold approximately $150 billion (or approximately €200 billion) devoted to European "special situation" strategies – should have an abundant supply of distressed assets from which to choose.

The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 5, Number 7 February 16, 2012

Potential Pitfalls for Hedge Fund Managers

In order to capitalize on this unique opportunity – which some have characterized as "the next great trade" – hedge fund managers will need to be well-versed in local law, particularly local insolvency law. Insolvency law is a trap for the unwary – particularly for those accustomed to freedom of contract – as it often provides for the unwinding of contracts and transfers, renders certain contract provisions unenforceable, and imposes often unforeseen risks and burdens (such as through a clawback of previously transferred assets). Therefore, hedge fund managers seeking to make distressed investments must be cognizant of the relevant risks and structure around them, to the extent possible. This is true not only in situations involving a formal bankruptcy or insolvency proceeding, but also where the borrower or issuer is insolvent, or is approaching insolvency, during which time certain transactions with the borrower/issuer are subject to particular ex post scrutiny.

Nonetheless, there are encouraging developments for hedge funds seeking to engage in special situations arising out of the UK and Europe. For one, restructurings in the UK/Europe increasingly have taken on a US style – in other words, restructurings of UK/European companies increasingly resemble those involving US names, albeit with different insolvency regimes. Moreover, it is likely that hedge funds making investments in the UK/Europe more often will be working alongside or negotiating against the same group of players with whom they had dealt in the past in relation to US strategies. Distressed fund managers, therefore, should feel quickly at home in managing UK/European situations. Second, an increasing number of European jurisdictions are enacting insolvency laws modeled in large part from the US Bankruptcy Code. As a result, insolvency laws generally have become more predictable than in the past, especially from the perspective of US-based distressed fund managers who are accustomed to dealing with US bankruptcy law. Rules vary in meaningful (and sometimes unexpected) ways, however, depending on the jurisdiction.

Types of Distressed Investment Strategies

For hedge fund managers who are able to navigate successfully through the uncertainties presented by local law, distressed investment opportunities are expected to abound, and in various forms. For one, a surge in distressed loan sales would provide fertile ground for distressed debt trading – for funds seeking to purchase at a discount with a view to holding the assets for the long-term (with the expectation that the underlying value will recover over time), or those who have no interest other than to buy at a favorable price and "flip" their investments for a quick profit.

Other managers may favor so-called "loan-to-own" strategies, whereby a hedge fund may acquire distressed debt with the goal of ultimately owning all or a portion of the shares in the company through a debt-for-equity conversion. A debt-for-equity swap can occur either through a court process – involving a formal bankruptcy/insolvency filing in which the presiding court would force the exchange upon dissenting creditors – or a consensual out-of-court restructuring.

Yet another form of distressed investment which has become more prevalent recently is what can be characterized as a "synthetic asset transfer." In a synthetic transfer, the transacting parties may use derivatives documentation (such as a total return swap) to transfer the value, and the risk, underlying the assets without the actual title being transferred between them. Transactions of this type – which

The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation
www.hflawreport.com Volume 5, Number 7 February 16, 2012

can be simple or immensely complicated, depending on the desired structure – may be appealing to banks that may wish to avoid the impression of having offloaded their assets to opportunistic hedge funds.

Solomon J. Noh is a Partner in the Bankruptcy & Reorganization Group at Shearman & Sterling LLP. Noh recently transferred from Shearman & Sterling's New York office to the London office to supplement the firm's distressed/restructuring capabilities in the UK and throughout Europe. Noh has a cross-disciplinary practice with involvement in derivatives, financing and mergers and acquisitions, all with a focus on distressed and bankruptcy situations. Noh also regularly represents debtors and creditors in Chapter 11 bankruptcies, out-of-court restructurings and cross-border insolvencies, and also advises lenders in various types of financing transactions. Noh's most recent focus has been on monoline insurance company restructurings and rehabilitation and representation of banks and hedge funds on risks relating to financial contract counterparty exposure, particularly in the context of the Chapter 11 bankruptcy filings of Lehman Brothers Holdings Inc. and its debtor affiliates. Noh, who began practicing in 2000, joined Shearman & Sterling in 2002. For related analysis by Noh, see "Treatment of a Hedge Fund's Claims Against and Other Exposures To a Covered Financial Company Under the Orderly Liquidation Authority Created by the Dodd-Frank Act," The Hedge Fund Law Report, Vol. 4, No. 15 (May 6, 2011).